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SUBJECT: LOCAL BUSINESSES LESS EUPHORIC THAN FINANCIAL MARKETS

1. Summary. Recent discussions with business executives in Bursa, Istanbul, Kayseri and Izmir indicate increased optimism about the economic recovery and the AK Government. But business people show none of the euphoria exhibited by the IMF- and politics-focused financial markets. There is widespread unhappiness over high tax rates and electricity costs. Though the executives are concerned over the lira's strength, their comments track with analysts, explanations of continued export strength. Corporate managers, complaints that the government needs to cut taxes while providing increased support reflect a lack of understanding of the GOT,s fiscal constraints. End Summary.

The Economic Recovery

2. In a series of recent meetings with visiting Econoffs in Istanbul, Kayseri, Bursa and Izmir, corporate executives were divided over how much the economy is improving. In Kayseri, business people cited the easing of inflation and concomitant reduction in interest rates, the end of the Iraq war (which has improved consumer confidence), and the Iraqi reconstruction effort as all contributing to economic growth. Both Ford/Koc and Toyota representatives confirmed press reports that, after a disastrous 2002, 2003 domestic car sales are up significantly. However, businesses are also concerned that the recovery remains fragile, and do not fully share the enthusiasm that has recently been displayed by the financial markets. Several businesses commented that domestic demand remains weak. Comment: These contradictory views are in line with positive but uneven GDP growth numbers, and highlight the fact that the financial markets, with their near-obsession with political and external factors, are way ahead of the "real economy." End Comment.

3. Despite the relatively undeveloped financial sector, businesses claimed they had adequate access to capital -- mostly in the form of their own equity. They say, however, that they are hesitant to invest until they are more confident about the durability of the recovery, and until the government reduces tax rates and otherwise improves the investment environment.

Exports/Competition

4. Executives confirm that exports are driving the recovery. For instance, TV/appliance maker Vestel expects exports to rise from \$1.1 billion in 2002 to \$1.5 billion this year. The lira,s strength versus the dollar is a concern, particularly to the textile/apparel sector. One exporter said he had shifted production from Turkey to Egypt, and government and analyst contacts have told of Turkish companies moving production to lower-cost Bulgaria and Romania. Because of high prices, manufacturers report being unable to fill many of their U.S. import quotas. However, the relative stability of the Euro vs. the TL has better protected businesses that export to the EU (70 percent of Kayseri,s exports are to the EU zone, and but 7-8 percent to the U.S.). Also, businesses with significant dollar-denominated inputs are not being hurt as much. Kayseri's Boydak conglomerate (which has just opened a New Jersey office), echoing comments made by others, stated that it is prepared to accept low profits for some time in order to maintain or build market share. Businesses that are more thinly capitalized, however, do not have this luxury. Comment: These statements track with analysts, theories as to why Turkish exports remain strong despite the appreciation of the Lira. A large share of the Turkish export sector -- particularly electronics and automotive companies -- has a natural hedge against lira volatility because of their foreign exchange-denominated inputs. Moreover, analysts and bankers have told emboffs that the 2001 crisis drove out all but the most efficient and fast-reacting entrepreneurs, especially in the textile sector, and led to significant productivity increases. End Comment.

15. Some textile/apparel manufacturers predicted the demise of their sector after quotas are lifted in 2005. They report already losing sales to Chinese competition in the U.S. and other export markets, and are keen to see U.S. trade safeguard action against Chinese goods. Others are more sanguine, viewing Turkey's customs union with the EU as providing them with a competitive advantage over Chinese goods. In contrast to their counterparts in Izmir and Bursa, executives in Kayseri were surprisingly indifferent to EU accession, and suggested it would not provide much of an economic boost beyond that already provided by the customs union.

Role of Government/Free Zones

16. Businesses consistently complained about high taxes and electricity costs. Because of widespread non-compliance, taxpaying businesses are charged very high rates. Several executives blamed the IMF for forcing GOT to raise taxes, and want the government to provide more incentives or infrastructure, showing little appreciation for the GOT's severe budget constraints.

17. The Aegean Free Zone and Kayseri Organized Industrial Zone, unlike most such economic zones, are doing well. Aegean Free Zone exports are up 42 percent through August, and employment is up from 10,000 to 10,500, with perhaps another 500 jobs to be added by year-end. Executives attribute this to tax breaks, and warn that a GOT decision to end those breaks would mean the end to new investment in the Zone. Comment: The IMF's direct tax reform proposal is designed to eliminate some of the Free Zone tax breaks, including exemptions from corporate and personal income tax. Though high tax rates are unquestionably a problem for the Turkish economy, the executives' complaints need to be balanced against the GOT's severe fiscal constraints and the IFI's legitimate concerns about the distortionary impact of so many generous tax incentives. End Comment.

18. With the exception of those in Izmir, the business people with whom we spoke were relatively satisfied with the current government, viewing it as business-friendly and trying to reduce corruption. Executives praised the GOT's commitment to privatization and the recently-streamlined company establishment procedures, under which businesses can now register in as little as one day. Izmir-based executives stressed the need for the government to continue to reduce its role in the economy, although this did not stop them from complaining that the government needed to offer more incentives and provide better infrastructure.

19. Comment: Our visits to regional commercial centers served as a useful reminder that Turkey's "real economy" is still going through difficult times, despite the financial markets' recent rally. This is not a criticism of Turkey's IMF-backed economic reform program, as there inevitably will be a time lag between implementation of reforms and increased domestic demand. However, our discussions highlighted the need for further structural reform -- privatizations, tax reform, improved investment environment, and better regulation -- if Turkey is to achieve the sustained growth and international competitiveness it needs to prosper.

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